Executive Summary

Government Sponsored Enterprises (GSEs) are private financial institutions set up by the federal government to direct credit into such areas as housing, agriculture, and higher education. The principal GSEs are:

- The Farm Credit System
- Farmer Mac
- The Federal National Mortgage Association (Fannie Mae)
- The Federal Home Loan Mortgage Corporation (Freddie Mac)
- The Federal Home Loan Banks
- The Student Loan Marketing Association (Sallie Mae).

GSEs were designed to remedy so-called market imperfections, many of which had been caused by the government itself in the form of restrictive laws and regulations. Today, most of these legal impediments have been reduced or eliminated, and most GSEs have accomplished their original public purposes. Most GSEs are thus largely unnecessary for the efficient flow of capital in the modern economy.

> *Today, most GSEs have accomplished their original public purposes.*

But there is a downside to GSEs. GSEs include the largest financial institutions in the world. Fannie Mae and Freddie Mac have outstanding liabilities and mortgage-backed securities of about $1.3 trillion. Add in the Federal Home Loan Banks, the Farm Credit System and Sallie Mae, and you have a contingent liability of about $1.5 trillion. And this taxpayer liability will only grow: On average, *Fannie Mae and Freddie Mac have more than doubled in size every five years since 1970.* But unlike ordinary private companies, GSEs do not automatically go out of business if they fail. And GSEs can and do fail. The Farm Credit System failed in the mid-1980s after losing $4.6 billion in two years. Because of their size, and because GSEs carry an implicit government guarantee on their loans, GSEs are a significant potential liability to taxpayers.

The federally-backed portions of the financial markets are beginning to interact in ways that the government did not anticipate. The federal government has not shown any special skill in anticipating and preventing problems with financial institutions and contingent liabilities. As proven by the S&L debacle, such massive taxpayer contingent liabilities are not risk-free.

> *The federal government has not shown any special skill in anticipating and preventing problems with financial institutions and contingent liabilities.*

Because GSEs are subject to a government charter, they are players in the political world. And because of their size, many of them are *significant* players in the political world. When problems develop with a GSE, backed by implicit government guarantees and motivated by politically influential private owners, the GSE seeks adjustments in the law to maintain and perpetuate itself. Today, Farmer Mac (the smallest GSE) is requesting changes to its charter that would increase taxpayer risk, and give it advantage over its competitors.

It is time to begin privatizing most government sponsored enterprises, because nearly all financial services that GSEs provide today are also available from effective private competitors, because most of the GSEs have accomplished their original public purposes, and to relieve taxpayers of the contingent liability.

> *It is time to begin privatizing government sponsored enterprises.*

Discussions about privatizing Sallie Mae are already underway. The Federal Home Loan Bank System is structurally vulnerable, and Farmer Mac should be transitioned out of its GSE status, rather than having its charter expanded. Privatization of GSEs through removal of their federal sponsorship and support will allow GSEs to become truly private companies, and will free taxpayers from unnecessary contingent liabilities.

SAYING GOODBYE WHEN THE JOB IS DONE: The Coming Privatization of Government Sponsored Enterprises

Introduction

The Federal government uses two major forms of backing for obligations of financial institutions: deposit insurance and Government Sponsored Enterprises (GSEs). GSEs are private financial institutions set up by the federal government to direct credit into such areas as housing, agriculture, and higher education. The principal GSEs are:

- The Farm Credit System
- The Federal Agricultural Mortgage Corporation (Farmer Mac)
- The Federal National Mortgage Association (Fannie Mae)
- The Federal Home Loan Mortgage Corporation (Freddie Mac)
- The Federal Home Loan Banks
- The Student Loan Marketing Association (Sallie Mae).

The federal government created the major GSEs as instruments of federal policy to overcome perceived market imperfections or market failures. Fannie Mae, for example, began in 1938 as a subsidiary of the Reconstruction Finance Corporation, a wholly owned government corporation. Its purpose was to provide a secondary market for federally insured mortgages. Congress intended the Federal Home Loan Bank System (FHLBS) to provide a source of liquidity to savings and loan associations. It designed the Farm Credit System (FCS) to be a sort of national bank to serve rural borrowers. More recently, Congress created the Student Loan Marketing Association (Sallie Mae) to provide a secondary market in student loans. Table 1 lists the federal contingent liabilities represented by GSEs as of September 30, 1994, compared with the contingent liability of federal deposit insurance.

Table 1

Face Value of Federal Contingent Liabilities: GSEs and Deposit Insurance Programs
FY1994, in $billions

Contingent Liability	Face Value	
Federal Deposit Insurance:		
Banks	$ 1,885	
Savings and Loans	691	
Credit Unions	253	
Total Deposit Insurance		**$ 2,829**[1]
Government Sponsored Enterprises (GSEs):		
Federal Home Loan Mortgage Corp.	567	
Federal National Mortgage Association	744	
Federal Home Loan Banks	197	
Student Loan Marketing Association	51	
Farm Credit System	51	
Federal Agricultural Mortgage Corp.	*[2]	
Total GSEs		**1,553**[3]
Funding Corporations:		
Financing Corporation (FICO)	9[4]	
Resolution Funding Corporation (Refcorp)	31	
Total		**$ 4,422**

[1]This number reflects federal deposit insurance up to the statutory limit of $100,000 per insured deposit account and does not reflect any additional contingent liability that would arise if the government extends its backing to uninsured depositors.

[2]Outstanding Farmer Mac Securities amounted to about $0.1 billion.

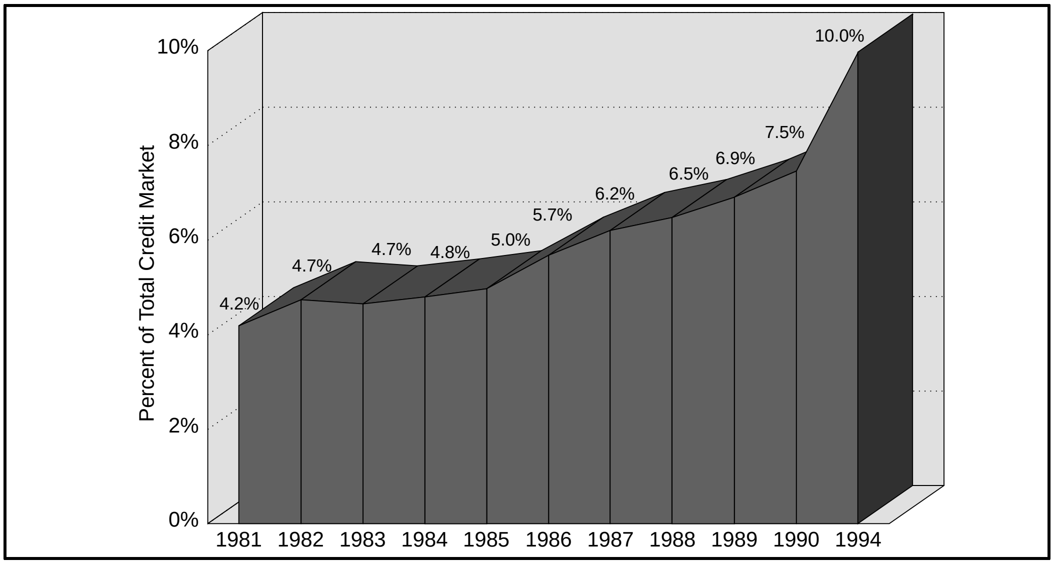
[3]This total excludes double counting of securities of one GSE that are held by another GSE (especially the FHLBS) for investment purposes.

[4]Repayment of most principal (but not interest) on FICO and Refcorp obligations will be made through the use of Treasury obligations that have been purchased for that purpose and held in segregated accounts.

GSEs are among the largest financial institutions in the United States. Fannie Mae and Freddie Mac together fund forty percent of the home mortgages in the country. They are each larger than Citicorp, the Bank of America, or any of America's largest bank holding companies or money center banks. Sallie Mae holds about forty percent of all guaranteed student loans. The Farm Credit System holds just under one-third of the farm real estate debt in the country.

Figure 1

Increasing GSE Share of Total U.S. Credit Market



Source: *Flow of Funds Accounts: Annual Flows and Outstandings, 1946-1993*; and *Flows and Outstandings, Fourth Quarter 1994*. Board of Governors of the Federal Reserve System, Washington, D.C.

Although nominally private companies, GSEs are still quasi-governmental institutions because they receive an implicit government guarantee of their obligations. Because of this implicit guarantee, they receive better terms when they borrow in financial markets. This frees GSEs from much of the market discipline that applies to ordinary companies. Instead, taxpayers are expected to bail out a GSE if it gets into financial difficulty.[1]

Risks Associated with GSEs

Federal backing for government-sponsored enterprises that operate with low capital and limited federal oversight helps to continue the practice of trading potentially great taxpayer exposure for limited benefits to the credit markets. *Yet, in return for the trillion dollars of taxpayer contingent liability for these GSEs, homebuyers have their mortgage rates reduced by only a fraction of a percentage point.*

If times remain prosperous for the GSEs, the small reduction in mortgage rates seems to be without cost. But, just as with the S&L debacle, these massive taxpayer contingent liabilities are not risk-free.

GSEs can and do fail. The Farm Credit System failed in the mid-1980s because of imprudent lending practices and its heavily-subsidized loans to farmers. The System failed after losing $4.6 billion in two years and required a federal loan to return to solvency.

Fannie Mae almost failed in 1981 because of excessive risk-taking. This took the form of "lending long and borrowing short." In other words, the GSE took on large amounts of short-term debt to fund long-term mortgages, only to find itself billions of dollars in the red after interest rates jumped. New management, federal support (including a special tax break) and a successful gamble on interest rates in the early 1980s helped restore profitability.

The current willingness of the new Congress to rethink old ideas makes this a good time to consider the future of the one-and-a-half trillion dollar contingent liability created by operation of the GSEs today.

Most GSEs No Longer Necessary

Over time the financial markets have become much more efficient. "Market imperfections" initially included statutory limits that confined potential competitors, such as banks and thrifts, and an absence of easily obtainable information about the riskiness of certain loans. Changing markets and improved laws (e.g., the repeal of legal limits upon bank branching and the geographic areas that banks and thrift institutions could serve) have alleviated many past imperfections.

Now that these perceived market imperfections have diminished, credit worthy borrowers have access to a broad range of financial institutions and services. GSEs can flourish only while their federal subsidy (derived from the implicit federal backing, various tax advantages and other benefits in their particular enabling legislation) gives them a pricing advantage that is attractive to customers. Financial services companies without GSE status may begin to offer attractive bundles of services that GSEs may be precluded from providing because of the limitations in their federal charters. If the pricing is competitive, these new products may attract customers away from some of today's GSEs.

The federal government has not shown any special skill in anticipating and preventing problems with financial institutions and contingent liabilities.

This may not be a tolerable situation for a GSE. As its federal charter begins to confine its activities, the GSE must push the limits, both in the market and in attempting to expand its permitted activities under the law. Several GSEs are in this position. The major GSEs are beginning to compete with one another, both at the margins and potentially with respect to some of their core businesses. The GSEs are also continuing to have effects upon the profitability of federally insured financial institutions in an increasing number of ways.

The federal government has not shown any special skill in anticipating and preventing problems with financial institutions and contingent liabilities. The pressures favoring the present establishment, often backed by powerful political constituencies, can immobilize government. If regulated financial institutions have suffered substantial losses, as the savings and loans and the Farm Credit System (FCS) did in the 1980s, the government looks for deep pockets and uses indirect and arcane ways to generate the money needed to pay off depositors and other investors who relied upon the government's assurances of safety and soundness.

> For several reasons, thoroughgoing privatization is an attractive exit strategy for a GSE, preferably before it runs into serious trouble. It is time to begin privatizing most government sponsored enterprises, because nearly all financial services that GSEs provide today are also available from effective private competitors, because most of the GSEs have accomplished their original public purposes, and to relieve taxpayers of the contingent liability.

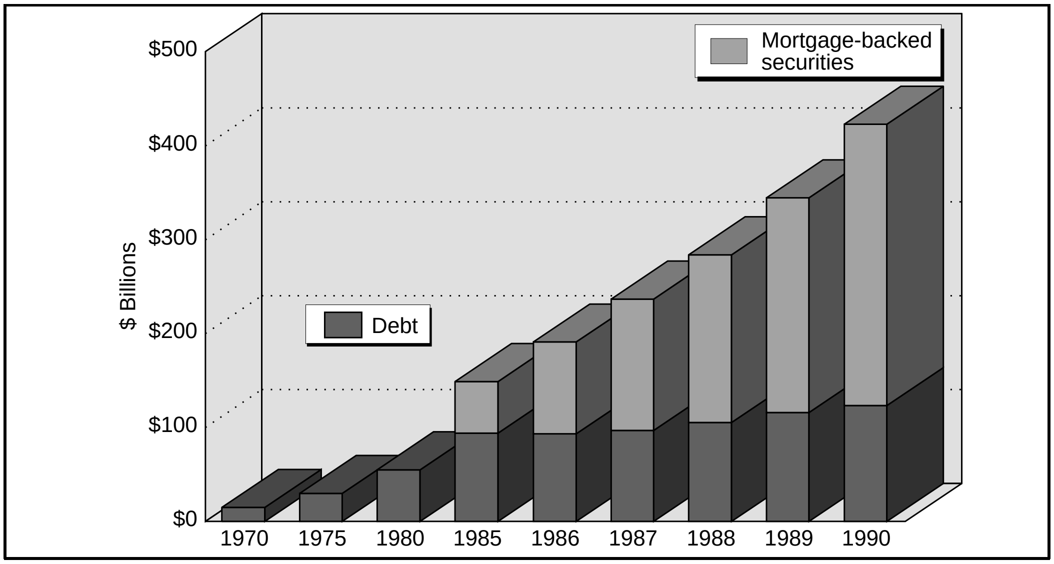
Today, the removal of government sponsorship from a GSE would have few adverse consequences upon the ultimate borrowers. Perhaps the most perceptible change will come as marginally increased borrowing costs that result from removal of the government subsidies.[2]

Fannie Mae and Freddie Mac

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) demonstrate how corporations backed by government subsidies can dominate their markets. These two companies are limited by law to purchasing or securitizing home mortgages up to a size limited by a statutory formula. The current mortgage limit is $203,150 for a single-family mortgage.

Figure 2

FANNIE MAE: Securities and Guarantees Outstanding at End of Year ($billions)



Source: Congressional Budget Office based on information from the GSEs. Debt includes notes, bonds, and multi-class debt securities (including subordinated debt).

Congress prohibits Fannie Mae and Freddie Mac from originating mortgage loans— they must purchase mortgages from other lenders. In today's market, the major types of primary mortgage lenders are mortgage bankers, commercial banks, and thrift institutions. Both GSEs have grown dramatically in the past 25 years. Their combined assets and mortgage-backed securities have more than doubled every five years, on average, since 1970. Today they are two of the world's largest financial institutions. As Table 1 (p. 3) shows, on September 30, 1994, Fannie Mae had combined liabilities and mortgage-backed securities outstanding of $744 billion; for Freddie Mac, the comparable figure was $567 billion. Together, the two GSEs represent a federal contingent liability of $1.3 trillion.

Fannie Mae and Freddie Mac resemble public utilities that are largely unsupervised by the government

Fannie Mae and Freddie Mac are very profitable, with average returns on equity last year of 24 percent and 23 percent, respectively. This return is far superior to the average of commercial banks or other private lenders. Fannie Mae and Freddie Mac resemble public utilities that are largely unsupervised by the government with respect to pricing or the scope of their services. In recent years, they have purchased over half of all home mortgages originated in the United States. The other half have consisted largely of three kinds of mortgages:

(1) adjustable rate mortgages held largely in the portfolios of thrift institutions and commercial banks;

(2) jumbo mortgages, i.e., those larger than $203,150 and therefore ineligible for purchase by Fannie Mae and Freddie Mac; and

(3) mortgages insured by the federal government, especially the Federal Housing Administration (FHA) of the Department of Housing and Urban Development (HUD).

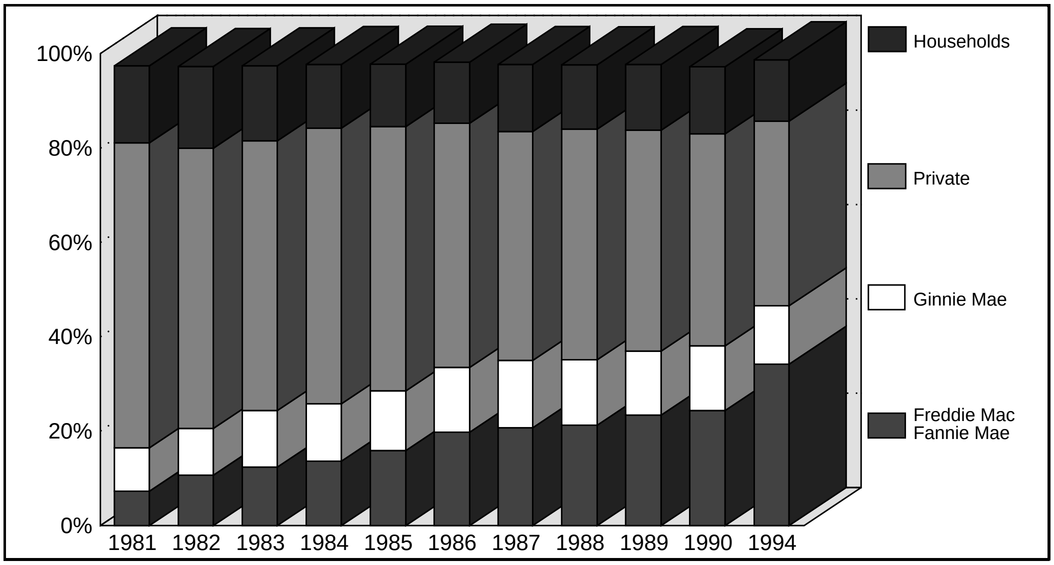


Figure 3

Government vs. Private Share of Outstanding Residential Mortgage Debt, Year-End 1981-1994

Source: *Flow of Funds Accounts: Annual Flows and Outstandings, 1946-1993*; and *Flows and Outstandings, Fourth Quarter 1994*. Board of Governors of the Federal Reserve System, Washington, D.C.

Three recent GSE actions deserve special note because of their implications for other parts of the American financial system.

Automated Underwriting

First, Fannie Mae and Freddie Mac are developing large scale automated underwriting and mortgage application systems based upon the most recent forms of information technology. Sallie Mae similarly used new information technologies to erase the borders between the primary and secondary markets. As with Sallie Mae, Fannie Mae and Freddie Mac are likely to be able to use the new technologies to push their market power forward from the secondary market into the primary market.

This development will permit Fannie Mae and Freddie Mac to reduce the cost structure of the primary mortgage market. Lenders will face the need to re-engineer the mortgage origination system of the United States. Also, the new automated systems will prompt change in the real estate settlement system and its myriad expensive services that could usefully be bundled with the loan origination process. This development is also likely to hasten the process of consolidation of mortgage lenders in the primary market.

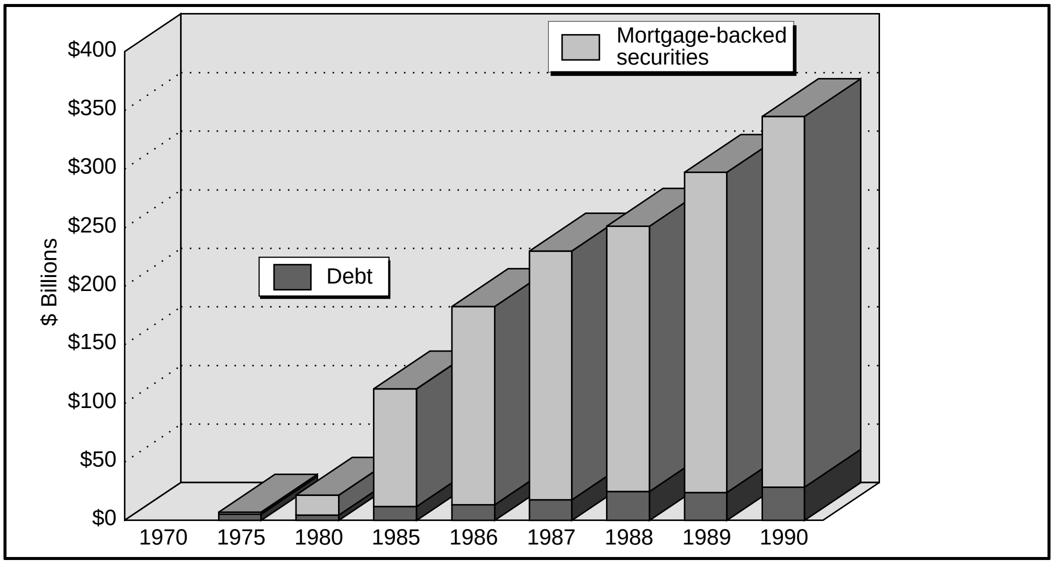
Credit Scoring Technologies

Second, Freddie Mac has introduced new information technologies to the process of credit scoring, and Fannie Mae is actively exploring the development of such capabilities. Readily retrievable information about the credit history of past borrowers can be matched with loan and property characteristics, and with the credit profile of a prospective borrower to assess the likelihood of default on the new mortgage. By placing the new credit scoring systems in the hands of primary lenders, Freddie Mac and Fannie Mae can improve the extent that they serve credit worthy borrowers whose mortgage applications they might have rejected in the past because of unusual credit histories. In particular, by focusing upon factors that relate solely to the credit worthiness of a particular borrower, the new credit scoring systems could reduce disparate treatment of racial and other minorities in the mortgage origination process.

As the conventional mortgage market has grown, it has attracted the more credit worthy borrowers away from the FHA. This process is likely to accelerate once Fannie Mae and Freddie Mac implement their new automated underwriting systems. The new systems are likely to identify many new credit worthy FHA-type borrowers who would then be able to receive a conventional mortgage with lower fees than they would have to pay for an FHA-insured mortgage. The new systems will also prompt reductions in closing costs that will increase the affordability of conventional mortgage loans. One result might be increased pressure upon the financial soundness of the FHA single-family mortgage insurance program.

Figure 4

FREDDIE MAC: Securities and Guarantees Outstanding at End of Year ($billions)



Source: Congressional Budget Office based on information from the GSEs. Debt includes notes, bonds, and multi-class debt securities (including subordinated debt).

Ever-Expanding Scope of Authorization

The third development has been an effort, especially by Fannie Mae, to expand the terms of the law and regulations that govern its permitted business activities. In 1989 Fannie Mae obtained a statutory change that removed restrictions on its authority to make loans on the security of mortgages. In 1990 Fannie Mae asked the Secretary of Housing and Urban Development to permit Fannie Mae to purchase debt obligations secured by conventional mortgages or securities backed by such mortgages. This would have permitted Fannie Mae to offer advances to thrift institutions, commercial banks and other mortgage lenders on quite favorable terms compared with those offered by the Federal Home Loan Bank System to its members. In particular, while the FHLBS has based much of its business upon the practice of making advances that are highly overcollateralized (to control credit risk), Fannie Mae proposed to reduce overcollateralization. This change would appear to make the proposed Fannie Mae advances quite attractive compared with those currently offered by the FHLBS. The Department of Housing and Urban Development refused to approve Fannie Mae's 1990 request; however, changes in the Department's regulatory authority mean that such approval may not be needed in the future.

> These three developments illustrate how Fannie Mae and Freddie Mac combine market power and political clout with an impressive ability to deploy new technologies to reshape the American mortgage market in ways that few policy makers may perceive. The consequences are beginning to spill over into other parts of the financial markets.

Expanded Political Power

A growth in their political power has accompanied the growth of Fannie Mae and Freddie Mac in the marketplace.3 In recent years Fannie Mae and Freddie Mac have faced a range of challenges in new legislation or regulations with the potential to enhance or impede profitability of the two companies. As with other federally chartered institutions, Fannie Mae and Freddie Mac have devoted considerable resources to assuring dominance in the political process. They achieved a major political victory in weakening legislation to create a strong financial regulator with discretion to set bank-type capital requirements. The results of GSE political power have been chronicled in many reports from a variety of sources. The Secretary of the Treasury has pointed out: "The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes."[4]

The principal GSEs . . . have significant resources with which to influence political outcomes.

One of the most attractive consequences of privatization of Fannie Mae and Freddie Mac would be the redirection of their energies to success in the marketplace rather than dominance in the political process. A fundamental flaw with the institutional structure of the government sponsored enterprise is that the government subsidy creates market dominance by some GSEs and this in turn creates the potential for political dominance.

Fannie Mae and Freddie Mac are so large and powerful today that the government may lack the will to compel them to accept privatization. An alternative, discussed below, might be to provide positive incentives now for the two GSEs to accept a sunset provision in their charter legislation that would require privatization in a few years.

The Federal Home Loan Bank System

On paper, the Federal Home Loan Bank System looks like a profitable venture. At year-end 1994 the 12 Federal Home Loan Banks had total assets of $245 billion, net income for the year of $738 million, and total capital of $13.3 billion. Despite the thrift debacle and the traditional dependence of the FHLBS on the thrift industry for its membership and customer base, the FHLBS has never lost a dollar on its advances to member institutions. This is a tribute to its requirement that advances to members be substantially overcollateralized to protect the FHLBS against default.

In 1989 the Congress opened membership in the FHLBS to banks and other mortgage lenders. The number of FHLBS members has almost doubled in the past five years, growing from 2,887 at year-end 1990 to 5,345 at year-end 1994. Today the commercial banks that are members of the FHLBS significantly outnumber the thrift institution members.

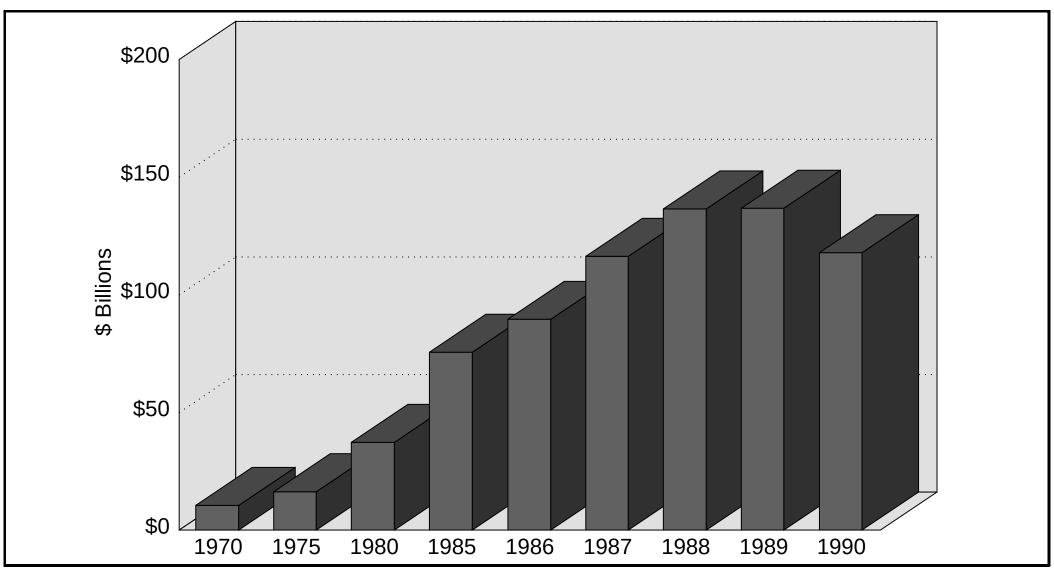


Figure 5

FEDERAL HOME LOAN BANK SYSTEM: Securities and Guarantees Outstanding at End of Year ($billions)

Source: Congressional Budget Office based on information from the GSEs. Debt includes notes, bonds, and multi-class debt securities (including subordinated debt).

Unwise and leveraged investments in structured notes, issued largely by the FHLBS and Fannie Mae, led to the bankruptcy of Orange County in California.

These impressive numbers fail to reveal some significant structural flaws in the design and current operation of the FHLBS. The most serious structural flaw relates to a financial requirement, imposed in 1989 legislation, that the FHLBS provide $300 million annually for forty years to fund obligations of the Resolution Funding Corporation (Refcorp), an off-budget government corporation. In 1989 the Congress also mandated the allocation of $2.5 billion in FHLBS retained earnings to capitalize Refcorp to pay for the closure of failed thrift institutions.

Another problem relates to the unusual capital structure of the FHLBS: The General Accounting Office points out that FHLBS capital "is not well-suited for absorbing risk."[5] Instead, it exhibits many characteristics of "borrower stock" with a powerful constituency that will argue that Congress should protect it against losses. This occurred when the Farm Credit System (FCS), also a cooperatively owned GSE, was unable to meet its obligations in the mid 1980s; the federal government ultimately decided to provide federal financing to restructure the FCS while protecting FCS stockholders from the kind of losses that would be appropriate for equity investors.

The problem with the required annual FHLBS payment to Refcorp is the way that it "introduces some perverse incentives into the FHLB System." The Refcorp payment imposes fixed costs upon the FHLBS, despite the profitability or income of the System in a particular year. The fixed $300 million Refcorp payment has created pressure on the FHLBS to increase its income-producing activities. As an official of the Federal Home Loan Bank of San Francisco, the largest of the Banks points out, "Our business is not to be in arbitrage.... But that [Refcorp] obligation has made it our business."

The FHLBS has increased its purchases of mortgage-backed securities, federal funds and commercial paper, for example, as a way to earn investment income. Federal Home Loan Banks engage in what the Congressional Budget Office calls "risk-controlled arbitrage."[6] The FHLBS taps the inexpensive federal agency credit market and uses the proceeds to purchase higher yielding assets. The FHLBS attempts to limit its risk from this activity, and the Federal Housing Finance Board (FHFB), the regulator of the FHLBS, monitors this risk when examining the Banks.

Any losses to the value of FHLBS stock in turn could have significant negative effects upon the balance sheets of thrift institutions.

The FHLBS reduces borrowing costs through a variety of techniques. For example, Federal Home Loan Banks have issued more than $44 billion of derivative securities known as structured notes.[7] These derivative securities have high credit quality but are susceptible to interest rate risk and market risk that can be difficult to predict. Unwise and leveraged investments in structured notes, issued largely by the FHLBS and Fannie Mae, led to the bankruptcy of Orange County in California. The financial officer of the FHLBS explained the issuance of structured notes by observing, "We have a hungry system to feed."[8]

The fixed Refcorp payments weaken the ability of the FHLBS to deal with the prospect of a few years of insufficient earnings. The Refcorp payment has given the FHLBS an incentive to increase its membership base; in a growing system, they can share the burden of the $300 million annual payment among more members. However, the converse is also true: If the annual income of the FHLBS were to decline perceptibly, the new voluntary members could redeem their FHLBS cooperative stock and give up their memberships.

This creates the possibility of a negative spiral, with low earnings precipitating a loss of membership that can hasten a further loss of members. The result would be an increased burden upon the fraction of FHLBS stock that mandatory members hold, i.e., federally chartered thrift institutions. Any losses to the value of FHLBS stock in turn could have significant negative effects upon the balance sheets of thrift institutions.

Under the law, federal bank and thrift regulators do not classify FHLBS stock as an equity investment; this permits banks and thrifts to maintain only a minuscule amount of capital to back their FHLBS stock investments.[9] A loss in value of FHLBS stock would be felt as impaired capital at many banks and thrift institutions that hold that stock.

The FHLBS continues to provide advances along virtually the same lines that it has done from its creation sixty years ago. It is not at all clear that the System can combine this financial product with risk-controlled arbitrage in the FHLBS investment portfolio to assure steady earnings until it retires the Refcorp obligation in the year 2030. One possibility, noted above, would be that Fannie Mae or Freddie Mac will eventually overcome the opposition of HUD and then will introduce one or more superior financial products with the potential to erode the market for highly overcollateralized FHLBS advances.

Congress needs to address these risks. The Congressional Budget Office (CBO), the General Accounting Office (GAO), and HUD all have made recommendations as to substantial improvements in the law governing the FHLBS. None has suggested privatizing the system.

As with Fannie Mae and Freddie Mac, estimates of the political strength of the FHLBS seem to preclude any action by Congress to require privatization. Instead, positive inducements may again be appropriate: In return for transforming the Refcorp obligation from a fixed $300 million assessment into a form of federal income tax (i.e., a variable assessment), and other necessary changes to the FHLBS charter, the FHLBS legislation could include a sunset provision that prescribed a transition process and complete privatization of the system in a few years.

. . . estimates of the political strength of the FHLBS seem to preclude any action by Congress to require privatization.

The Farm Credit System

The Farm Credit System continues to recover from its failure in the mid-1980s. The FCS has repaid all of the funds used for the financial rescue and continues to increase its capital. The proportion of FCS capital that is “borrower stock” continues to decline as a fraction of available funds. The FCS now includes a cushion of funds that are available through the new Farm Credit System Insurance Corporation.

The FCS too has begun to be affected by the activities of other GSEs. Fannie Mae has inaugurated a new rural housing initiative, and some FCS institutions have become approved Fannie Mae Seller / Servicers for purposes of originating rural home mortgages.

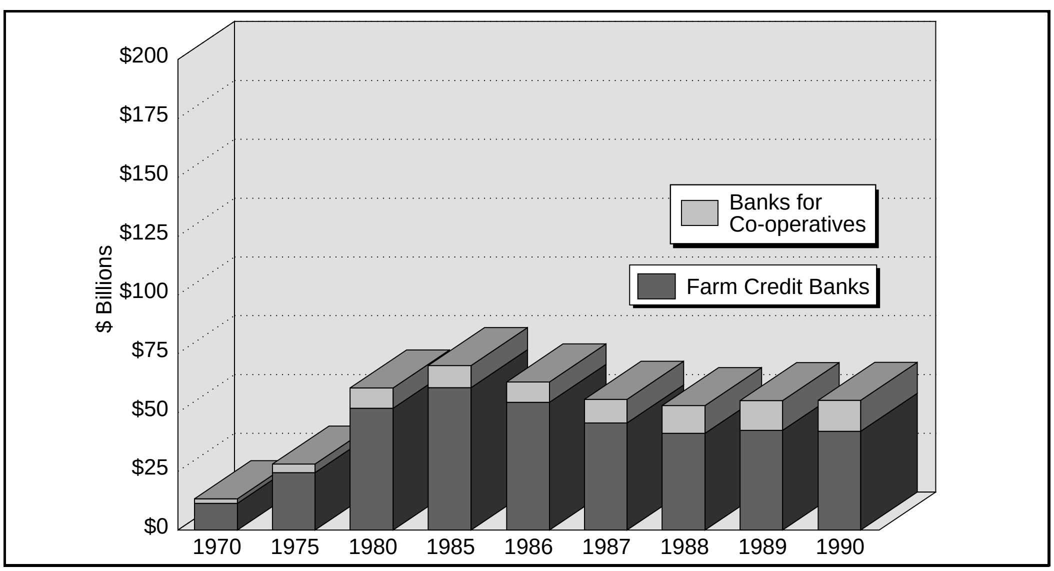


Figure 6

FARM CREDIT SYSTEM: Securities and Guarantees Outstanding at End of Year ($billions)

Source: Congressional Budget Office based on information from the GSEs. Debt includes notes, bonds, and multi-class debt securities (including subordinated debt).

The activities of the FHLBS are of greater potential significance to the Farm Credit System. As the FHLBS expands its membership the FHLBS is beginning to provide advances to rural commercial banks. These banks are the natural competitors of the Farm Credit Banks.

Historically, FCS market share has grown when the commercial banks have faced constraints upon their liquidity (i.e., available loan funds). Also, commercial banks have been limited in their access to longer term money that would permit management of interest rates of their assets and liabilities if they make longer term fixed rate agricultural mortgage loans. Now, however, FHLBS advances to rural commercial banks have the potential of providing longer term funds in ample quantity and preventing such reductions in liquidity. This could begin to affect the long-term market prospects of the FCS, especially if commercial banks obtain legislation to relax current restrictions upon their access to FHLBS advances.

The FCS eventually needs to give up its status as a GSE in return for the greater flexibility of doing business as a lender under state laws.

One countervailing factor concerns the mergers and acquisitions of rural commercial banks that are currently taking place. The new larger commercial banks may find more attractive opportunities in serving larger customers or non-farm credit needs and may be less willing to serve smaller and mid-sized farmers. Farm borrowers then might be expected to turn in greater numbers to the FCS. In contrast to a commercial bank, the FCS must continue to serve agricultural credit needs even during periods when other opportunities might promise greater returns.

Another trend relates to the consolidation taking place among farm borrowers themselves. A recent analysis documents the decline in the number of mid-sized farms and points out that these have been the traditional borrowers from the FCS. The larger agricultural borrowers and vertically integrated producers have access to the international markets and use the FCS Banks for Cooperatives as part of an array of sources of funds at competitive rates; smaller farmers have off-farm income and relationships with commercial banks that often displace reliance upon the FCS banks and associations for credit. The FCS eventually needs to give up its status as a GSE in return for the greater flexibility of doing business as a lender under state laws. Congress should make plans now to facilitate such privatization.

Farmer Mac

Congress designed the Federal Agricultural Mortgage Corporation (Farmer Mac) to issue guarantees of securities backed by pools of agricultural mortgages. However, except for a small loan pool that Farmer Mac securitized in 1994, the corporation's loan securitization has been dormant since 1992. Farmer Mac's other line of business is to provide a secondary market for loans guaranteed by the Department of Agriculture. This business has grown, but not by enough to offset the lack of volume in the corporation's securitization business. The company is eating into its capital and is unlikely to survive under its current charter.

The government would be well advised to work with Farmer Mac to develop a prompt privatization strategy or simply to wind up the affairs of the corporation

Farmer Mac is seeking legislation to alleviate some features of its charter considered to make securitization unprofitable. Features of special concern to Farmer Mac have been the requirements (1) that Farmer Mac use an outside entity to pool loans for securitization, (2) that Farmer Mac securities be based upon creation of a 10-percent subordinated interest in each pool and that the private parties that hold the subordinated interest be subject to first losses, and (3) that statutory capital requirements be phased-in completely by 1996.

Such changes would permit Farmer Mac to offer borrowers an opportunity to arbitrage across federal capital requirements. Farmer Mac capital standards would be much lower than those required for the FCS and for commercial banks, its competitors. Lower capital requirements may permit Farmer Mac to offer more attractive prices for its loans than these competitors.

Special legislation for Farmer Mac would raise important competitive issues for the future of the Farm Credit System. Farmer Mac recently obtained Senate committee approval of legislation to operate essentially as a portfolio lender with far lower capital than is required for the FCS or for commercial banks. If this legislation is enacted, Farmer Mac would gain the potential to underprice the Farm Credit System and eventually to attract much of the agricultural mortgage business that today is funded by FCS institutions.

Farmer Mac . . . is eating into its capital and is unlikely to survive under its current charter.

Unless Farmer Mac is willing to accept serious capital standards (comparable at least to those that currently apply to its competitors), the government would be well advised to work with Farmer Mac to develop a prompt privatization strategy or simply to wind up the affairs of the corporation. Farmer Mac is a specialized lender that serves an agricultural sector whose financial cycles can be quite volatile. The federal government saw in the thrift debacle that relaxing capital requirements for financially weak specialized lending institutions can be risky, and especially for those that are investor-owned with consequent incentives to compound their risk-taking in times of financial stress.

Sallie Mae

The Student Loan Marketing Association (Sallie Mae) is a GSE that wants to give up its GSE status and become a corporation chartered under the general purpose laws of a state. Sallie Mae's current activities as a GSE could be replaced by increased securitization of student loans, by expansion of existing large portfolio lenders and secondary market institutions, the new federal direct student loan program and by the possibility of continuing activity from Sallie Mae after its transition to a general purpose private company.

Yet Sallie Mae appears to face some obstacles in achieving privatization. The corporation's circumstances highlight the problems of changing the status of a large

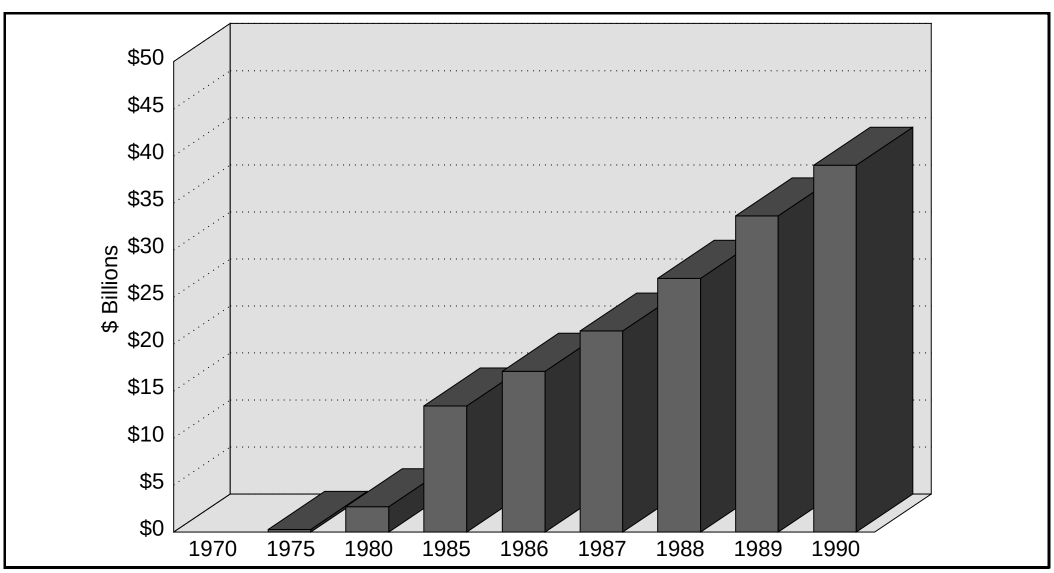


Figure 7

SALLIE MAE: Securities and Guarantees Outstanding at End of Year ($billions)

Source: Congressional Budget Office based on information from the GSEs. Debt includes notes, bonds, and multi-class debt securities (including subordinated debt).

financial institution. Some issues relating to privatization may arise from the larger political controversy over the future form of the federal student loan program. The Department of Education has called for the liquidation of Sallie Mae if the GSE declines to become completely private. The Treasury Department has also urged privatization of Sallie Mae, stating that,

> "The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from Federal sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist."

The Financing Corporation and the Resolution Funding Corporation

The Financing Corporation (FICO) and the Resolution Funding Corporation (Refcorp) are government corporations designed to have the attributes of GSEs. They are owned in essence and controlled in fact by the federal government rather than by private parties. *Their formal status as GSEs permitted the government to finance the closure of insolvent thrifts without recording the outlays in the federal budget.*

One consequence of this subterfuge is the long-term impact of the $300 million annual Refcorp payment on the stability of the Federal Home Loan Bank System, as described above. A second consequence relates to the problems that arise when private parties fear that the government will act unilaterally to upset what they consider to be the agreed rules of the game. Because Congress twice legislated to take retained earnings from the FHLBS, the Federal Home Loan Banks now resist retaining further earnings, thus reducing the cushion of capital in the system.

The third consequence relates to the impact of the Financing Corporation on the future of the thrift industry. The FICO legislation requires annual assessments on thrift institutions to pay for deposit insurance through the Savings Association Insurance Fund (SAIF) of the FDIC, and requires the FDIC to set the premiums while taking account of the level needed to pay for the FICO obligations.

Their formal status as GSEs permitted the government to finance the closure of insolvent thrifts without recording the outlays in the federal budget.

If the FDIC sets the thrift insurance premiums high enough to pay for FICO obligations, then a thrift institution charter will become much more expensive than a comparable commercial bank charter. This will occur in the context of steadily shrinking deposits at thrift institutions. The result could be what the Congressional Budget Office calls a “death spiral,” with declining thrift deposits requiring higher FICO assessments upon the remaining thrift deposits, and with this in turn increasing the pressure for shrinkage of the insured deposit base.

Another complication is the advances that thrifts and commercial banks receive from the FHLBS. Thrift institutions and banks may be able to increase their use of FHLBS advances (for which they pay no federal insurance premium despite the implicit government backing of the FHLBS) and thereby reduce their use of insured deposits that are subject to the insurance premium.

Conclusion

The two major forms of backing for obligations of financial institutions used by the federal government, deposit insurance and GSE status, are beginning to run into one another. The federally backed portions of the financial markets are beginning to interact in ways that the government did not completely anticipate beforehand.

Even worse, legislative and regulatory opportunities present themselves as narrow issues that individual congressional committees and government agencies deal with in isolated fashion, without considering the unintended consequences that later appear. No one in government appears to have the larger financial picture entirely in view. The dynamism of the private financial markets increasingly calls into question the ability of the government to deal with the complicated consequences of providing a federal guarantee for the obligations of private investor-owned companies.

Excerpts from the Testimony of Darcy Bradbury, Deputy Assistant Secretary of the Treasury for Federal Finance,

Before the Subcommittee on Postsecondary Education, Training and Lifelong Learning of the Committee on Economic and Educational Opportunities and the Subcommittee on National Economic Growth, Natural Resources and Regulatory Affairs of the Committee on Government Reform and Oversight,

United States House of Representatives, May 3, 1995.

"The Treasury has for a number of years, in Democratic and Republican Administrations, believed that it is appropriate to wean a GSE from Federal sponsorship once the GSE becomes economically viable and successfully fulfills the purpose for which it was created with Federal sponsorship, or when the purpose for which it was created ceases to exist.

"The GSEs expose the Government to the market perception of implicit risk that legislation would be enacted to prevent a GSE from defaulting on its obligations. . . . The prospect that Congress would use taxpayer funds to prevent the failure of a GSE is perceived in the securities markets as protecting investors in GSE debt securities or GSE-guaranteed securities from loss . . . .

"As a general principle, we believe that the Government and the GSEs would benefit from removal of the Government ties because privatizing the GSEs would:

- Reduce the amount of GSE debt, over time, that carries some perception of U.S. Government support;
- Demonstrate our commitment to moving from creating effective public-private partnerships to then enabling complete privatizing when Government support for an activity is no longer needed;
- Show the financial markets that the Government respects the interests of private bond- and shareholders; and
- Support Federal efforts to create new GSEs in the future, when appropriate, by demonstrating that the Federal relationship can be severed when the time is right. A business operation that starts as a GSE with a limited charter can be freed to operate in other markets once it has fulfilled that purpose for which it was created.

". . . privatizing Sallie Mae would significantly benefit the U.S. Government. In addition, removing Federal ties would mean that the restrictions on Sallie Mae's business operations under its current charter would cease to exist and that Sallie Mae could engage in profit-making activities that it cannot enter as a GSE.

"The Administration believes that the benefits to be gained by the Government and Sallie Mae from privatization . . . are such that Congress should favorably consider legislation to authorize Sallie Mae's management to form a fully private company and to wind down the GSE during a transition period.

"Privatization, if implemented in a careful and deliberate manner, can benefit the U.S. Government and taxpayers, as well as Sallie Mae's . . . stockholders, and the students and schools we are all trying to serve."

Some Issues to be Addressed in Privatizing Government Sponsored Enterprises

Practical Aspects of Privatization

Because GSEs are legally privately owned, the term "privatization" needs some explanation. For GSEs, privatization is *the removal of government sponsorship or support from the activities of a financial institution so that it can participate in the markets as a completely private firm without the benefits and limitations that attach uniquely to a GSE charter.*

The fact that ownership of the GSE is already in private hands simplifies one aspect of its privatization. All that needs to be done is to remove the government guarantee of its securities. By contrast, the process of privatization of a state-owned enterprise requires sale of assets or of a going concern to one or more private entities that pay the government for the value of the acquisition.

The privatization of a GSE is feasible and practical. Agencies of the federal government have studied issues relating to the process of privatizing the largest GSEs, Fannie Mae and Freddie Mac.[10] Sallie Mae has prepared a variety of documents concerning its desire to privatize.

However, the politics of privatization is not easy. During the Reagan Administration, policy makers made many proposals to remove GSE status from Fannie Mae and Freddie Mac and other GSEs. All of these proposals failed. And since the 1980s, the political power of the larger GSEs (with the notable exception of Sallie Mae) has grown.

GSEs are specialized lenders that lack experience making tradeoffs among financial services for diverse types of customers.

One interesting practical issue involves the divergence of interests between GSE managers and their private shareholders. As a matter of law, the directors and officers of an investor-owned corporation have a responsibility to maximize value to the shareholders. However, managers of federal corporations may confuse their personal interests in perpetuating the status quo with the interests of shareholders in maximizing value, which might be best achieved by dissolving the particular firm. The income tax laws compound this inertia by rewarding retention of earnings rather than corporate distributions to shareholders.[11]

> In one celebrated case, managers failed to assess the true benefits of operating in a competitive market. This was the breakup of the Standard Oil Company in 1911, pursuant to court order in an antitrust case. Shares of stock of the successor companies were distributed to shareholders of the Standard Oil Company. The new companies were much more adroit than the old monopoly and could exploit new technologies (notably the thermal cracking process) stifled by the rigid bureaucracy of the parent company. Within a year of the restructuring the value of the stock of the successor companies had doubled. Yet, the Standard Oil Company had fought the government for years to prevent the breakup.

Fear of a more competitive environment is likely to beset managers of some GSEs. Perhaps the most acute case is that of the Federal Home Loan Banks. The Federal Home Loan Banks take virtually no credit risk in their transactions. This could make it difficult for them to contemplate survival in a market that might require them to underwrite loans before they extend credit.

New competition becomes a factor because of the tradeoff that privatization brings to a GSE: The institution gains freedom to engage in a broad range of activities, unconfined by the constraints of the current GSE charter, in return for giving up the special benefits (the implicit federal guarantee, tax breaks, etc.) that the government provides through the charter. The GSEs would lose some of their ability to compete in current lines of business in return for the opportunity to engage in new activities without the peculiar risks and limitations associated with a federal GSE charter.

The Federal Home Loan Banks take virtually no credit risk in their transactions.

One problem with competition involves the transition period and the possible inability of today's GSEs to take prompt advantage of any new freedom to engage in new activities, if they do not plan ahead. GSEs are specialized lenders that lack experience making tradeoffs among financial services for diverse types of customers. Commercial banks and other lenders have such experience. The larger private financial services companies use sophisticated systems and internal rates of return calculations based upon marginal costs and revenues to decide how to allocate resources among alternative lines of business that are consistent with the overall corporate strategy; GSEs, confined currently to more narrow market niches, may have little experience making such decisions in a competitive and volatile market-based environment.

The result might be that some GSE managers fear the consequences of privatization for themselves and their institutions. Such fears would be especially pronounced among those senior GSE executives whose skills relate more to political dominance than to the market-related abilities that the companies will value more after privatization.

Approaches to Privatization

Some general approaches suggest themselves as ways to deal with these issues. First, a sunset date should be established for the privatizing and canceling of the old GSE charter, and the sunset date should be set far enough in advance that the parties would have time to prepare. When a prospective sunset date is set several years in advance, the investors, managers, customers, and competitors can use the time to adjust to the changes caused by privatization. The transition period also provides an opportunity for the GSEs to set aside some resources to capitalize non-GSE affiliates. Managers can use these affiliates to build experience competing as non-GSEs in preparation for the time when the entire company gives up its GSE status.

The government might offer a package to Fannie Mae and Freddie Mac that would include:

(1) a sunset provision to the Fannie Mae and Freddie Mac charters that would provide for privatization in a fixed number of years, and

(2) opportunity for the two GSEs to present a privatization plan that includes a transition period so that the companies could explore and develop experience in new lines of business likely to be profitable once they gave up their GSE charters.

By contrast, for a GSE such as Farmer Mac, whose charter seems to have little value compared to alternatives, the process of privatization will resemble corporate reorganization or dissolution. This would be an attractive possibility in the context of efforts to reduce the size of outstanding federal contingent liabilities.

It should be possible to resolve technical issues relating to such a concept; it will be equally important to resolve the political issues so that there is general commitment to privatization by all parties once the transition period begins.

Otherwise the transition period would create two kinds of risk: If the non-GSE affiliates run into difficulty, GSE managers will attempt to run back to the protection of government backing. By contrast, if the affiliates appear too successful, then their competitors may try to force the GSE back into the constraints of its original charter.

Once agreement to privatize is reached, then there must be commitment by the government to see it through. That is why the sunset date cannot be too far in the future. Also, the Congress might reinforce the government's commitment by setting an exit fee so that budget scoring rules are triggered by any obstruction of the privatization process.

Recommendations

The federal government has created a contingent liability for the taxpayers of some $1.5 trillion to back the activities of GSEs. The government lacks the capacity to monitor the activities of the GSEs and their interactions with one another and with the banks and thrifts and other institutions backed by federal deposit insurance.

The activities of the various GSEs with one another and with the federal deposit insurance system are beginning to collide in complicated ways. This makes it important for the government to take the following steps:

- **Create a central office with the responsibility and capacity to monitor federal contingent liabilities.**

To protect against the type of "capture" that the Treasury warned about in its 1991 report on GSEs, Congress should establish the office in the Treasury or Federal Reserve Board. Preferably the office should submit its reports directly to a strong congressional committee such as House Ways and Means that can protect the free flow of high quality information. It should have the mandate and authority to obtain information and publish reports. However, to avoid the prospect of confrontation over regulatory matters, the office should not have regulatory responsibilities.

While we should always be wary of creating new government offices and bureaucracies, in the case of the GSEs, the existing taxpayer liability makes such a monitoring structure necessary. Also, this office would exist only until the GSE privatization effort was completed.

- **Disentangle the interrelationships of GSEs and federally insured financial institutions.**

It is time to begin disentangling some interlocks among federal contingent liabilities. One interlock with significant safety and soundness implications is the ability of federally insured banks and thrifts to own stock of GSEs without reserving appropriate capital. This contrasts with the outright prohibition that usually applies to bank holdings of private equity securities. The Federal Home Loan Bank System presents this issue in its most pressing form. The Congressional Budget Office points out that any loss of value of FHLBS stock could have serious effects upon the capital of the institutions, and especially the thrift institutions, that hold it. This is because of the anomaly in the federal risk-based capital requirements, discussed above, that permits thrift institutions and many banks to hold only a minuscule amount of capital (1.6 percent) to back the value of their investment in FHLBS stock.

The capital rules are only slightly better with respect to the capital (8 percent) required to back bank and thrift investments in equity securities of the other GSEs. These rules too should be changed so that GSE stock is treated on a parity with its actual risk qualities. Again the reason is safety and soundness: Unlike GSE obligations, stock of a GSE does not benefit from legal attributes that imply federal backing. Such stock is potentially as risky as any other stock issued by a private company of comparable financial strength.

Changing these rules is important. Otherwise the structural infirmities of the FHLBS, were they ever to cause losses, or weaknesses in stock value of any other GSE could spill over into the thrift and banking industry. Congress should change the rules prospectively, with a transition period, to permit the markets and institutions to adjust to the new rules.

It would be wise to repeal the special laws that permit banks, thrifts, and Federal Home Loan Banks to invest in the stock of GSEs without regard to the investment limits that otherwise apply to their holdings of equity securities of private companies. Again, such change should apply prospectively after a transition period. The purpose of this change is to reduce the concentration of risk that can arise if a federally backed institution invests too heavily in equity securities of any particular privately owned company.

- **Begin negotiations with GSEs with respect to privatization.**

It is time now to begin negotiations with the GSEs about their future relationship with the federal government. The case deserving the most prompt attention is that of the Federal Home Loan Bank System. The current structure is not stable, and it is important that the structural infirmities not merely be patched up to postpone unforeseen difficulties to another day. Virtually any negotiations with the FHLBS should include a sunset provision that would prescribe a transition to non-GSE status in specified number of years.

The other pressing case is that of Farmer Mac. It is time to ease the corporation's transition out of GSE status rather than trying to tinker with a charter to create a new statutory niche in an agricultural market that is well served by other federally backed lenders.

Negotiations with Sallie Mae are already underway. One hopes that these discussions can be concluded with a form of privatization that represents a mutually beneficial outcome for all parties, including the taxpayers.

The government is currently studying the desirability and feasibility of privatizing Fannie Mae and Freddie Mac. These two GSEs do not appear to welcome the prospects of any privatization legislation. The GSEs wield significant power, to paraphrase the Treasury, "to influence political outcomes." Congress should remember this lesson before it contemplates creation of any new GSEs.

The government assignment of FHLBS and thrift industry resources to help pay for FICO and Refcorp once seemed to be an expedient way to get money for the savings and loan bailout. It turns out that here too, the GSE model does not provide a free lunch. Distortions caused by the ongoing FICO and Refcorp obligations need to be addressed. Perhaps some form of user fees on GSEs, and transformation of the FHLBS obligation into a responsibility to pay federal income taxes, can deal with these long term contingent liabilities.

Finally, the Farm Credit System, having gone through the wringer once, seems in fairly good shape to try to withstand the next downward phase of the agricultural credit cycle. Experts have already forecast that FCS institutions may run up against their charter limits and need to give up GSE status. Some forward planning now might facilitate that transition. Again, the message needs to be stressed that one can make the options more attractive if institutions try to privatize before rather than after their current charter has lost value.

- **Most proposals to charter new GSEs are flawed. If it is necessary to create a new GSE, place a sunset provision in its charter.**

The Johnson Administration made Fannie Mae a GSE because it needed to achieve budget savings. Today's budget pressures are likely to create opportunities for special interests to suggest creation of a variety of GSEs as a way to put federal functions off-budget. Indeed, as with a proposed GSE to serve small business investment companies, they are likely to call such a GSE a "privatization" of a government function;[12] this has the potential to confuse any perception of the continuing government involvement that a GSE represents.

The financial failure of the Farm Credit System in the mid 1980s and the massive federal funding to pay for the savings and loan debacle have convinced responsible policy makers of the need to assure that any new GSEs will be financially sound. This research suggests an additional concern: In creating a GSE, the government must avoid the extremes represented by the failure of Farmer Mac on the one hand and by the untrammeled financial dominance of Fannie Mae and Freddie Mac on the other. In today's volatile financial markets, it is difficult if not impossible to legislate to create a statutory niche for a new GSE that escapes both extremes.

Finally, if the government creates any new GSEs, it needs to prepare now for the prospect of privatization. Legislation to create a new GSE should provide for sunset in a prescribed number of years and for an orderly transition away from GSE status. Only this way can the government protect against creation of new federally backed institutions whose public purposes are rendered irrelevant by the rapid developments that take place in today's efficient financial markets.

For Further Reading

Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises*, (Washington, DC: Congressional Budget Office), April 1991.

Ronald C. Moe, *Managing the Public's Business*, Committee on Governmental Affairs, United States Senate (Washington, DC: GPO), April 1995.

Harold Seidman, "The Quasi World of the Federal Government," *The Brookings Review*, Summer 1988, pp. 23-27.

Thomas H. Stanton, *A State of Risk*, (New York, NY: HarperCollins, 1991)

Thomas H. Stanton, *Taxpayers at Risk: The Moral Hazards of the New Mercantilism*, (Lewisville, TX: Institute for Policy Innovation), June 1992.

U.S. General Accounting Office, *Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks*, (Washington, DC: GAO / GGD-91-90), May 1991.

U.S. Treasury Department, *1990 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, (Washington, DC: GPO), April 1990.

U.S. Treasury Department, *1991 Report of the Secretary of the Treasury on Government-Sponsored Enterprises*, (Washington, DC: GPO), April 1991.

Endnotes

1. There is a large literature on the problems and risks associated with GSEs. Among the more important recent contributions are U.S. Treasury Department, *Report of the Secretary of the Treasury on Government Sponsored Enterprises, May 1990* (Washington: U.S. Government Printing Office, 1990); U.S. Treasury Department, *Report of the Secretary of the Treasury on Government Sponsored Enterprises, April 1991* (Washington: U.S. Government Printing Office, 1991); U.S. General Accounting Office, *Government-Sponsored Enterprises: The Government's Exposure to Risks*, GAO/GGD-90-97 (August 1990); U.S. General Accounting Office, *Profiles of Government-Sponsored Enterprises*, GAO/AFMD-91-17 (February 1991); U.S. General Accounting Office, *Government- Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90 (May 1991); Thomas H. Stanton, *Government Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy* (Washington: Association of Reserve City Bankers, April 1988); Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (Washington: U.S. Government Printing Office, April 1991).

2. For example, the residential mortgage market is divided between conforming mortgages, i.e. those eligible for purchase by Fannie Mae and Freddie Mac, and nonconforming mortgages. The spread between conforming and nonconforming mortgages amounts to perhaps three-eighths of a percentage point. That figure is a reasonable approximation of the impact upon borrowers if Fannie Mae and Freddie Mac were completely privatized. By contrast, the federal government includes a mortgage interest deduction in the federal income tax code that provides roughly five or ten times that amount of benefit to eligible home buyers.

3. The Washington Post recently reported on Fannie Mae's use of market power to enlist political support: "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington." David A. Vise, The Money Machine: How Fannie Mae Wields Power, January 16, 1995, p.A14.

4. 1991 Report of the Secretary of the Treasury on Government-Sponsored Enterprises, (Washington, DC: 1991), p. 8.

5. US General Accounting Office, Federal Home Loan Bank System: Reforms Needed to Protect its Safety, Soundness and Effectiveness, pp. 57-59, December 1993.

6. Congressional Budget Office, The Federal Home Loan Banks in the Housing Finance System, p.26, July 1993.

7. Randall Smith and John Connor, "Matter of Security: Risky Derivatives are Huge Source of Funds for Federal Agencies," Wall Street Journal, pp. A1 and A7, at A7, January 20, 1995.

8. Amy Barrett, "Riskier and Riskier at the Home Loan Banks: the federal system's new investment strategy raises eyebrows," Business Week, January 30, 1995, p. 78.

9. Banks and thrift institutions must keep at least eight percent capital available to back commercial loans that they hold on their books. The Federal Deposit Insurance Corporation (FDIC) and Office of Thrift Supervision include FHLBS stock in the 20 percent risk-weight category. This means that the bank or thrift needs to maintain only twenty percent of that eight percent capital requirement, or 1.6 percent total capital. By contrast to the FDIC, the Office of Comptroller of the Currency requires its supervised banks to maintain eight percent capital to back FHLBS stock that they hold.

10. The Treasury Department, the Department of Housing and Urban Development, the Congressional Budget Office and the General Accounting Office are preparing reports to Congress pursuant to the 1992 law that requires studies of the feasibility and desirability of privatizing Fannie Mae and Freddie Mac.

11. This is well-settled law. See, e.g., Dodge et al. v. Ford Motor Co. et al., 170 N.W. 668 (Mich., 1919).

12. National Association of Small Business Investment Companies, Memorandum from Peter McNeish to Philip Lader, Administrator of the Small Business Administration, February 6, 1995. The new GSE would be known as the Venture Capital Marketing Association, or Vickie Mae.

About the Author

Thomas H. Stanton is a Washington, D.C. attorney who specializes in financial regulation, government corporations and federal credit programs. He is a fellow of the Center for the Study of American Government at the Johns Hopkins University, where he teaches on the law of public institutions. Mr. Stanton helps to teach the annual seminar on government enterprises conducted by the National Academy of Public Administration. His writings on government involvement in the credit markets include a book on government sponsored enterprises, A *State of Risk* (HarperCollins, 1991), and many articles. Mr. Stanton has his B.A. from the University of California (Davis), M.A. from Yale University and J.D. degree from the Harvard Law School.

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